Impaired Investment Policy
EFC Adopted December 17, 2007

210.9 **Impaired Investment Policy**

1.0 Purpose

1.1 This policy is adopted by King County's Executive Finance Committee to address the treatment of impaired investments, as defined in Section 2.0, consistently with applicable law and the terms of the investment agreements with pool members. The policy addresses how to provide fair and equitable treatment of pool members' interests in the event one or more of the pool investments becomes impaired.

1.2 The policy specifically addresses situations involving pool members who are completely withdrawing from the pool or who are removing substantial funds from the pool prior to the distribution of any realized loss.

1.3 The policy amends King County Investment Policy Section 210 by adding a new subsection 210.9 titled "Impaired Investment Policy."

2.0 Definitions

2.1 Impaired Investment: An investment is deemed to be "impaired" when: (a) its credit quality is rated below investment grade by Standard & Poor's, Moody's and/or Fitch; (b) a default has occurred on payment at maturity; or (c) an enforcement event, as defined in the investment's program documents, has occurred. An impaired investment is also referred to as "distressed."

2.2 Unrealized Loss: A loss calculated using the fair value of the investment, but which has not been realized through a transaction such as the sale of a security. It is also referred to as a "paper loss." An unrealized loss is not distributed to pool members.

2.3 Realized Loss: A loss that is recognized when investments are sold for a price lower than the carrying value or it is determined that the investment has no value and therefore it is not possible to sell the security at any price. This loss is distributed to pool members.

2.4 Fair Value: This is the amount at which an investment is being exchanged in a current transaction between willing parties. In conditions where market pricing is not available, other generally recognized valuation methodologies may be used.

2.5 Par Value: This refers to the nominal or face value of a security. The par value is the amount the issuer is obligated to pay the investor when the security matures.

3.0 Goals

The policy is intended to serve the following goals among others:

3.1 Seek Options to Recover Principal: The pool will first seek options that allow for the recovery of the principal value of the impaired investment over time, thereby avoiding a realized loss. Any selected option must be justified in terms of risk, cost/benefit, and legal soundness.

3.2 Distribute Any Realized Loss Fairly and Equitably: If a loss must be realized, the loss will be distributed in a manner that is fair and equitable to pool members, as set forth in this policy.

3.3 Protect New Monies Entering Pool: The pool will seek to isolate a realized loss impact in such a way that new monies entering the pool after an investment is deemed impaired will not be factored into the calculation and distribution of the realized loss.

3.4 Prevent a Run on the Pool: The county will not allow members to exit the pool or remove substantial balances from the pool in order to avoid loss exposure, thereby undermining the confidence of remaining pool members. The county will ensure that those pool members completely exiting the pool or withdrawing substantial funds from the pool are required to leave sufficient funds in the pool to offset the maximum potential future realized loss on any investment that is impaired at the time of withdrawal or exit.

4.0 Distributing a Realized Loss—Holding Period Method

4.1 A realized loss will be apportioned based on each pool members' average cash balance from the time the impaired investment was acquired through the date the investment is deemed impaired. This is referred to as the "holding period" for the impaired investment.

4.1.1 Example: An impaired commercial paper investment acquired on April 18, 2007 enters into an accelerated enforcement event on October 17, 2007. If the total realized loss to the pool is $10 million and a pool member has an average cash balance equal to 1 percent of the pool during this time period, then the pool member is apportioned $100,000 for the loss.

4.2 This treatment of losses protects new monies which enter the pool after the date an investment is deemed impaired from being exposed to a realized loss associated with an impaired investment.

4.2.1 Example: If a pool member had a $50 million bond issue that was placed in the pool after the date an investment is deemed impaired, then this new $50 million would not be part of the member's average cash balance during the designated holding period for the purpose of calculating their share of the realized loss.

5.0 Pool Members Exiting Pool Prior To Realized Loss Distribution

5.1 Members who request a compete withdrawal of funds from the pool prior to a realized loss must first ensure that their request is consistent with their signed investment agreement, including prior notification requirements.

5.2 Retainage for Loss Coverage: The county will require the exiting pool member to retain sufficient funds in the pool to cover any future realized loss on an impaired investment. The county will calculate the pool member's pro rata share of an estimated 100 percent loss of the par value of the impaired investment using the holding period method set forth in section 4.0. This amount will be deducted from the requested withdrawal of funds and will be retained by the pool until such time that the pool recovers the full par value of the investment or distributes a realized loss. If a realized loss is less than the amount being retained by the pool to cover losses, this difference will be reimbursed to the exiting pool member at the time the realized loss is allocated to pool members.

5.2.1 Example: A pool member requests the withdrawal of $10 million on the anniversary date of their pool agreement and provides proper advance notice. The pool member has an average cash balance equal to 1 percent of the total pool assets during a defined holding period for an impaired investment. The par value on the impaired investment is $50 million. The amount retained by the pool to cover any loss is $500,000 (1 percent x $50 million). Therefore, the net withdrawal payment is $9.5 million ($10 million - $500,000 retained for loss coverage). Of the $500,000 retained by the pool, all or a portion of this amount will be returned to the exiting pool member depending on whether the full par value is eventually repaid to the pool.

5.3 If the county is issued a new security (or securities) as part of a restructuring solution for an impaired investment, then the full retainage amount will be returned to the pool member upon the full maturity payment of the new security (or securities). Also, if a restructuring solution results in periodic cash flow payments or the partial repayment of the par value of an impaired investment, these payments will be distributed to pool members.

5.4 Pool members will continue to receive interest earnings, as set forth in their investment agreements, on the amount of their retainage for loss coverage.

6.0 Pool Members Removing Substantial Funds Prior To Realized Loss Distribution

6.1 Members who request withdrawals of their cash balances must make the request consistent with their signed investment agreement, including prior notification requirements.

6.2 Retainage for Loss Coverage: Prior to approving the request, the county will calculate the amount of funds that must be retained in the pool to cover the pool member's share of any future realized loss on an impaired investment. The retainage for loss coverage will be calculated and applied in the same manner as Section 5.0.

7.0 Accounting and Financial Reporting for Impaired Investments

7.1 The Governmental Accounting Standards Board (GASB) promulgates accounting guidance. GASB 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools, provides guidance for investment accounting. Additionally, GASB also provides guidance through questions and answers in its annual comprehensive implementation guides.

7.2 In accordance with GASB 31, the investments in the county investment pool are reported in the county's year-end financial statements at fair value. That valuation takes into account any impaired investments.

7.3 If fair value is not determined by quoted market prices, the GASB Implementation Guideline suggests the security's value be estimated. This estimate calculation requires professional judgment and use of valuation techniques. In these cases, the County will obtain an estimate of the fair value from an investment bank of high reputation and solvency.

7.4 All investment income, including changes in the fair value of investments is recognized as revenue in the county's statement of activities. Negative investment income is reported as negative revenue.

7.5 GASB 31 does not mandate the manner, frequency or method of the distribution of investment earnings. The county, as the pool sponsor, determines the distribution methodology.

7.5.1 Based on longstanding past practice, the county only distributes realized gains and losses to pool members. The county does not distribute unrealized gains or losses on its investments.

8 Period of Applicability

8.1 This policy reflects applicable statutes, GASB 31 and standard accounting practices, the terms of the agreements with pool members and the actual practices that have been followed in the past management of the pool and therefore applies to all withdrawals, exits, or other events that fall within its subject matter scope.